ENGLISH METHODS OF LENDING AS CONTRASTED WITH AMERICAN

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Dissimilarities between English and American methods of lending are extraordinary in significance rather than in number. The principal points of contrasts may be attributed in the first instance to differences in geographical or physical conditions. The restricted area of England has made it peculiarly dependent upon other countries for raw materials and for markets for its manufactures. It has meant for England the concentration of a large part of its energies on the development of its foreign trade. The vast extent of the United States, on the other hand, has placed us under no similar necessity as to markets and materials. Great natural resources have enabled us to work with a wide margin of profit. England in its foreign trade has been compelled to work with a much narrower margin. Differences in margins of profit mean differences in necessity as to measures of economy, and herein we find the true basis of the more important elements of variance as respects English and American banking practice.

The effect of money rates on the profits arising from the development of natural resources, in mining, in the raising of grain and cotton is relatively small. On the contrary it is an item of prime importance in manufacturing industries, particularly in a country situated as is England. Our shipper receives payment for his raw cotton through the sale of time bills of exchange drawn on London or Liverpool as the case may be. The amount of dollars which he will receive for a given amount of sixty days' sight sterling bills depends directly on the rate at which these bills can be discounted in the London market, a high rate acting as a deduction from the price at which the sale and purchase of the cotton were arranged and a low rate having the opposite effect. The shipper, in other words, wants to be able to discount his bills at a low rate. If he can do this it means, other things being equal, a slightly higher price for his cotton. Conversely, it means that he can afford to take a slightly

lower price to the ultimate advantage of the English manufacturer of cotton goods. Whether, therefore, the discount rate is three per cent or five per cent is of material consequence to such manufacturer, adding to or lessening his cost of production and going far toward determining his ability to compete in foreign markets.

Likewise the probability of no extraordinary fluctuations in discount rates is of value in that it makes possible forward contracts for purchases of materials upon a favorable basis. A seller who can be reasonably sure that he will be able to discount his bills three or four months later at three per cent or four per cent or even five per cent will naturally be willing to take a less price for his goods than if there was a possibility of much higher rates prevailing at the time of the fulfilment of the contract.

The enormous responsibility which falls upon the English banking system to keep down money rates and to prevent wide fluctuations finds no counterpart in the United States. It is perhaps due to the fact that in England the function of the banks in lessening the cost of materials entering into manufactures and of imported food supplies is a matter of more or less general recognition, and banks are left comparatively free of legal restrictions which might tend to lessen their ability to meet the exigencies of the situation; whereas our comparative self-sufficiency in the matter of food supplies and raw materials has had the effect of minimizing popular interest in the workings of our banking laws and making difficult reforms which would inure to the public good. It is, at any rate, this difference in responsibility which accounts in a considerable degree to differences in methods of lending.

The most striking peculiarity of English banking practice, when brought into contrast with our own, is the use in the London money market of time bills of exchange as a basis for short loans, for a day or for a week. An explanation may be found in the fact that the extension of British foreign trade has carried with it the creation of a great amount of time bills of exchange, whereas the development of a new country of large area, such as the United States, occasioned the issue of a large amount of stocks and bonds of railroads and other industries, so that the loans of our American banks and English banks are naturally based upon quite different classes of securities. This explanation, however, is not sufficient. It does not take account of the fact that as a basis for loans, according to Eng-

lish practice, bills of exchange are made to rank side by side with British consols and other government guaranteed securities. It affords no reason why bills of exchange are made in the estimation of the English banker to rank above, so far as their utility as a basis for short loans is concerned, English railroad, industrial and municipal bonds and stocks which are not only sound in themselves but whose total is amply sufficient. The real explanation goes back to the difference in necessity of maintaining low and stable money rates. In involves, moreover, a further, though closely related distinction, between English and American banking objectives. This distinction is that England's prestige in the trade of the world is bound up in the preservation of London's position as the international banking center, while in a country as large as the United States, banking capital is necessarily spread over a wide area, a situation which militates against its concentration in New York and relieves us of any immediate ambitions to contest London's supremacy.

As differentiated from stocks and bonds, bills of exchange possess singular qualities with reference to their desirability as collateral to loans. They represent in large measure actual goods in transit. They are evidences of specific trade transactions. Within a short period they "will turn themselves into money." They therefore contain within themselves essential elements of security. Furthermore, the purpose which under ordinary circumstances is served by a loan on bills of exchange is one of high economic interest. In the London money market bills are dealt in by brokers who make their profits by financing their purchases by means of a loan and later selling the bills on a discount basis lower than that on which they were bought. In consequence, the lowering of the rate for short loans directly influences the market discount rate, and to that extent tends to lessen the cost of importing materials from abroad, thereby acting as a stimulus to trade and industry.

Apart from these considerations, there is a scarcely less important reason for the position occupied by bills of exchange in relation to short loans under the English banking system. It is that loans based upon them can, to a far greater extent than advances secured by stocks and bonds, be called with a minimum of market disturbance. Bills of exchange in the very nature of things are not suited to general investment purposes. They are not a form of

security which can be readily handled by private investors. Their early maturity and low yield make them undesirable. The margin of profit in buying them is also too small to warrant speculation in them in the ordinary sense of the word.

The absence of public interest and speculative positions in the securities, bills of exchange, upon which a part of his loans are based relieves the English banker to this extent of the anxiety attached to lending upon stocks and bonds. He is left with a comparatively free hand. Almost his sole consideration needs be his own position. His sense of security is twofold. In the first place any considerable calling of day-to-day loans is fraught with materially less risk to the general situation than if they were secured by stocks and bonds. Such a process does not involve the possibility of provoking realizing sales of securities by speculators who may either be frightened at the withdrawal of accommodations or who see in it an opportunity to make a profit on the short side of the market. It does not involve the public at large and lessens the danger of a rapid spread of alarm and the precipitation of a panic.

Another element of safety to English banks in the practice of lending upon bills of exchange is that the calling of such loans does not absolutely necessitate the borrower securing fresh money in London. When a joint-stock bank requires a bill broker to reduce his loans the latter first turns to some other joint-stock bank, or if he cannot make suitable arrangements there he can always fall back upon the discount facilities of the Bank of England. Even this resort, however, is not final in anything like an emergency, and for the following reason: Sterling bills of exchange are a favorite form of investment among continental banks and their transference from the loan departments of London banks to the discount portfolios of, for example, Paris banks, is neither unusual nor difficult. Almost immediately there is such a contraction in London money market supplies as to raise discount rates above the levels prevailing in European centers, and funds begin to move to London from these centers for investment in bills. Many of the great continental banks have London agencies, so that the process of shifting loans on bills is rendered doubly simple.

Loans upon bills of exchange are, in a word, loans which are essentially secure in themselves; they are of direct benefit to trade and industry even to the extent of operating to lower the cost of

the workingman's food supplies; they may be called without fear of reaction upon the lender, inasmuch as widely held investment securities are not involved; and they may be readily shifted to foreign banking institutions. The safety therefore with which banks lend their money on bills of exchange contributes to the effectiveness of the English banking system in meeting the primary requirements of low money rates and the maintenance of London's position as the financial center of the world. In the first place the assurance that its loans, or a considerable part of them, are liquid to an extraordinary degree enables a bank not only to lend at a low rate but lessens the necessity of maintaining a large cash reserve, which in turn means an addition to the supply of loanable capital with a tendency further to depress rates. In the second place it minimizes the danger of a collapse of the credit fabric such as we experienced in 1907. London's methods of lending are calculated to avert a similar situation so far as England is concerned, a situation in a material degree made possible by our practice of placing our almost sole reliance upon stock-exchange securities as collateral for day-to-day advances. Doubt as to the strength of certain banks led to withdrawals of deposits. Withdrawals of deposits made necessary the replenishment of reserves by the calling of loans. The calling of loans resulted in liquidation on the stock exchange. Falling prices of securities tended to spread alarm among investors generally, carrying with it further withdrawals of deposits, necessitating in turn the calling of other loans, until we reached the point when for practical purposes demand loans were little more callable than time loans. Unlike London we could not shift a part of our loans to Paris. The French banks saw a difference between bills of exchange with but a few weeks to run, and stocks and bonds the market value of which might be considerably less than the amount loaned within an equal length of time.

London's prestige rests as much upon its ability to withstand financial shocks, to ward off panics, to continue payments in gold at any and all times, as it does upon its great resources. In fact an important part of the resources which enable it to maintain low money rates and to handle great international loan operations is due to the position which it has so long occupied. Its bank deposits are not purely English. They are made up in part of foreign accounts, representing remittances from all quarters of the globe.

London cannot afford that these foreign deposits should be jeopardized. Their protection the English banking system has as one of its main objectives, and the success with which it has been accomplished rests in large measure on that practice of lending which has no place in our banking methods.

It is important to understand, however, that while English bankers have two classes of securities of different character, stocks and bonds and bills of exchange, on which to base their call loans, our bankers are of necessity confined to but one. The explanation lies in a further fundamental difference in the practice of lending. Briefly, it is that English banks lend their credit while our banks, national banks in particular, are prohibited by law from similar procedure. The practice also has its origin in that working principle of the English banking system, *i. e.* the safer bank loans and discounts can be made the lower can be the money rates afforded, and the cheaper England can buy and sell in foreign markets. The process is simple. When an English importer is about to buy materials in a foreign country he secures permission from his banker to have the bills of exchange drawn on him, the banker. In other words, for a small commission, the banker takes the place of the importer as the drawee and becomes, as the acceptor of the bills, responsible so far as any other banker is concerned, for their payment at maturity. These are the bills, bankers' bills as they are called, which are chiefly employed as a basis for short loans. These are the bills to which the Bank of England rate applies and which command the finest market discount rates, rates, in fact, usually lower than that of the Bank of England. Obviously the guaranty of a banker of high standing adds an important element of security to bills of exchange as a basis for the lending or investment of bank funds. It is an additional assurance to the foreign exporter that he can discount his bills at a low rate so that he can afford to make a favorable price to the English buyer. It makes them all the more satisfactory investments for foreign banking institutions.

The practice of lending by means of acceptances, so large a factor in the development of England's foreign trade and a substantial protection to the London money market, giving extraordinary security to loans and rendering more easy their partial shifting to continental institutions in times of stress, differs in no essential particular from the use to which credit is put in ordinary commercial

transactions. Apart from his financial resources the principal asset of a business man is his credit, founded upon the excellence of his judgment, his honesty, the carefulness of his methods and his past successes. It is a legitimate asset, one of which he is entitled to make use in securing accommodation from his banker. Under the English banking system, bankers are regarded as possessors of credit and are permitted to make use of it, to lend it. Under our system the credit of our banks is forbidden similar employment. Under our laws it is effectually locked up. There is something parodoxical about our prohibition of a practice of lending so important to English and so common with continental banks. When a bank loans its deposits it is loaning something which does not belong to it, something which it may be called upon to return any day. On the other hand, when it loans its credit, its good name, it is loaning something peculiarly its own, something indeed which in course of time may be lost but while possessed is not subject to withdrawal from day to day.

The extraordinary waste of bankers' credit in this country as compared with the effectiveness of its use under the English banking system is difficult to justify. The most plausible argument is that the use of such credit may very readily lead to its abuse. Aside from the fact that a similar argument applies to almost any device of marked utility, it must be admitted that continued prohibition of the practice of lending by means of bankers' acceptances, safeguarded as it may be by providing that such acceptances shall be given only in connection with mercantile transactions and that every bank-accepted bill of exchange shall bear on its face a clear indication of the nature of the security upon which it is based, is an expensive measure of protection against possibly only occasional instances of bad banking.

The capital and surplus of our banks now amount to something like four thousand millions of dollars. The resources of our national banks alone amount to ten thousand millions of dollars. The possession of such vast sums in part their own, in part entrusted to them, is an indication of the honesty of management, soundness of judgment as to risks, and past successes of our banking institutions. It is an indication of the extent of their credit, credit which according to English banking practice would, in part at least, be put

to work, but which with us takes no part in advancing the great economic processes of production and distribution.

In England the lending of credit by means of acceptances is practiced both by the joint-stock banks and merchant bankers, but in what proportion cannot be stated definitely as the latter publish no reports. There is, however, a considerable difference as to the ratio between capital and acceptances as regards the two classes of bankers. It is regarded as safe for merchant bankers to accept bills to an amount several times their capital. The acceptances of the joint-stock banks, on the other hand, average only about seventy per cent of their paid-in capital and surplus. Taking into account the small cash reserves of the joint-stock banks, the limitation of acceptances by our banks to their capital and surplus would seem to err only on the side of conservatism. On this basis the total waste of banking power under our present methods of lending would appear to be roundly $4,000,000,000. If we reduce this amount by one-quarter in order to leave out of account small institutions and those not actively engaged in commercial business, we still have a remainder of $3,000,000,000, or a volume of credit sufficient to provide a banker's acceptance for bills of exchange to cover our total annual imports of merchandise and still leave an unused balance of an equal amount, $1,500,000,000. In short, the unused credit of our largest and most powerful banks alone would be sufficient to guarantee all foreign drawn bills, giving them a value and standing not possessed by drafts on individual importers.

In discounts, as well as short loans, there is a sharp contrast between English and American methods. English discounts fall into two classes, bank bills and trade bills, the difference depending on whether or not the acceptors are bankers. The former are principally taken into account in the general discount market. The latter, under ordinary circumstances, are bills discounted direct by customers of banks with the banks where their accounts are kept. As they are not equally liquid assets they do not command as favorable rates as bankers' bills. A large proportion of the discounts of our banks, on the other hand, are made up of promissory notes, a class of paper occupying a much smaller place in English banking practice.

The distinction between promissory notes and bills of exchange, bankers' bills in particular, underlies much that is dissimilar in our

banking situation as compared with that of England. Bills of exchange, as has already been indicated, arise out of particular commercial transactions. They are evidences of definite purchases and sales of commodities. They refer to and generally carry with them control over specific shipments of goods. Their discount by a bank is essentially that of providing funds to carry through a single business operation, the satisfactory conclusion of which is within the scope of a banker's judgment. Such bills, for example, represent so much cotton or so much wheat, and the banker can determine for himself with reasonable certainty the probability of the success of the venture. It is not so with our commercial paper. The promissory notes which form the bulk of our bank discounts do not so far as the banker is concerned refer to specific transactions. They do not on their face evidence the character of the particular operations which have rendered necessary accommodation from a banker. Without such evidence there is always the possibility that instead of the discount of the paper partaking of the nature of a temporary measure to relieve a temporary need it in reality becomes a loan of capital for general employment in the business, capital which in an emergency might not be able to be withdrawn without disastrous consequences. When a bill of exchange is drawn at ninety days' sight against a shipment of merchandise there is every assurance to the banker who discounts it that he is not contributing to a possible lock-up of capital. On the other hand, the discount of a promissory note does not carry with it any guarantee that a renewal will not be asked for or arranged elsewhere. Furthermore, our practice of discounting promissory notes, as contrasted with the English practice of confining discounts in large measure to bills of exchange, in and of itself places no check on the volume of notes or paper which may be distributed among a number of banks by a single concern.

Unquestionably the barrier which our laws have raised against the practice of bank acceptances has had a great deal to do with restricting discounts to commercial paper. Moreover, there is reason to believe that the removal of present restrictions would give a decidedly different character to our discounts—that bank-accepted bills of exchange would to a large extent be substituted for promissory notes, carrying with them as they would the additional security of a bank guaranty and evidence of the temporary nature

of the transaction. Doubtless much of our commercial paper is based upon mercantile transactions which could as well be expressed in time bills of exchange, inland as well as foreign. While English joint-stock banks confine their acceptances to foreign drawn bills, their reason for discriminating against inland bills is not that the business is unsound. By accepting inland bills they believe it might be made to appear that they were short of cash else they would have made their customer a straight loan. Obviously such a consideration is not applicable to conditions in this country where banking capital is divided into much smaller units.

The substitution of bills of exchange for promissory notes would not involve any complicated change in our business practice. Instead of a New York importer buying goods in England, borrowing from his bank in order to provide funds to remit in payment, he would arrange with his bank to accept on his behalf time bills drawn on it by the English shipper, the documents to accompany the bills and to be delivered by the bank to the importer under a trust receipt or the goods warehoused by the bank and kept under its control until the importer had had time to dispose of them, within, of course, the period covered by the currency of the bills. Similarly, a St. Louis dry-goods merchant would arrange for his bank to accept bills of exchange drawn on it by a New York wholesale house which had sold certain goods to him. The New York bank, upon presentation to it of a formal letter of credit issued by the St. Louis bank to its customer in favor of the New York wholesale house, would immediately discount the bills. Furthermore, the issuance of a letter of credit would be in many cases unnecessary, owing to the facility with which the New York bank could secure telegraphic confirmation from the St. Louis bank that it would accept certain bills accompanied by certain shipping documents. In short, there is no apparent reason why the principles which govern foreign trade operations should not apply equally well to domestic, particularly in a country of the dimensions of the United States.

One of the most far-reaching effects of our practice of confining discounts to promissory notes is that such discounts become to a large extent fixed investments, fixed in the sense that they may not be readily transferred from one bank to another, from a country bank to its reserve agent, without adding to the liabilities of the former. This is primarily due to the fact that the security for the

ultimate payment of the paper is dependent upon the financial strength of the maker and that the paper carries on its face no indication that the original discount or subsequent rediscount do not constitute an over-extension of credit. Discounts of bank-accepted bills of exchange are of quite another character. Not only do such bills, with shipping documents attached, indicate the nature of the transactions they cover, but, what is more important, their endorsement adds nothing to their security. When a powerful London banking house has on behalf of one of its clients accepted certain bills of exchange, that is, guaranteed by means of its signature their ultimate payment, it is obvious that the endorsement of such bills by a small country bank for purposes of rediscount would add nothing to their security; and, adding nothing to their security, does not for all practical purposes involve any liability upon the part of such bank. Similarly if a great New York bank had accepted certain bills of exchange drawn on it, and a country bank had purchased these bills from a broker as a short-time investment, and, later, finding its needs for cash increasing, decided to rediscount the bills, it could do so without adding to its liabilities, except in the technical sense that if the New York bank failed to meet its obligation as to the payment of these particular bills, the country bank, having endorsed them, would have to take them up.

As far as a few of our largest banks are concerned, whether they did or did not rediscount would not alter the application of the principle involved to our banking situation. As a matter of fact London clearing banks do not rediscount bills with the Bank of England, although there is nothing to prevent their doing so except custom. They accomplish, as we have seen, somewhat the same end by lending on bills to bill-brokers who do rediscounting. The smaller clearing banks regard the custom as an unnecessary hardship. The large ones rivaling in resources the Bank of England itself, and possessing hundreds of branches which are in reality so many country banks, are not to be compared in the matter of rediscounts with the thousands of small banks in the United States.

In the last analysis, we find that, notwithstanding differences in geographical or physical conditions as between England and America, English methods of lending, though widely different from our own in certain fundamental particulars, are not such as would not bear adoption in this country. They appear rather to be

methods most likely to make bank discounts more liquid assets, most likely to increase the public confidence, both at home and abroad, in the soundness of our banking institutions by effectually dissociating our short loans from operations in speculative securities, most likely to give full play to our banking power, as expressed not only in tangible resources but in credit as well, most likely to stimulate trade and industry but making possible lower and less fluctuating interest rates, most likely to increase our ability to compete in the markets of the world, and most likely to inject into our banking system many of those elements of stability for which the English banking system is so renowned.